No. 158

IN THE

Supreme Court of the United States

OCTOBER TERM, 1951.

THOMAS B. LILLY AND HELEN W. LILLY, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

REPLY BRIEF FOR PETITIONERS

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PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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The respondent's brief in opposition indulges in a number of misconceptions, both factual and legal. We wish to call the Court's attention to some of the more basic errors.

1. The respondent has sought to envelop the petitioners in an atmosphere of evil and corruption which he apparently attributes to them. As the petitioners have stated and as the record clearly reveals (Pet. 3-4), the payment of rebates to doctors was a settled industry practice when the petitioners entered the optical field.[1] In order to survive

[1] The respondent does not deny that the evidence to this effect is clear and uncontradicted. Instead he resorts to the frail excuse that the evidence consists of "statements, often self-serving, of various witnesses." (Resp. 15.) The evidence in question was direct oral testimony subject to the usual safeguards provided by cross-examination.

the petitioners had to pursue an established practice which was not of their own choosing. To suggest that the petitioners initiated a policy of corrupting physicians is to indulge in naive imagination.[2] Needless to say, the petitioners would have been very glad to retain the sums paid to the doctors if competitive conditions had permitted them to do so.[3]

The various medical resolutions and editorials quoted by the respondent graphically indicate that the custom of rebates was a widespread business practice. In 1946 the Department of Justice was "informed that the rebating practice is industry wide." The Department meticulously supplied details which embraced Chicago, Dallas, Oklahoma City, Minneapolis, and Denver. In a number of instances the rebates taken by the physicians exceeded the sums retained by the opticians. The Department stated that "some individual physicians receive as much as $40,000 annually in rebates." "Moreover, the actual cumulative figures indicate that one group of physicians in Iowa received more than $42,000. One physician in a small town in Texas received almost $15,000, a sum equaled by physicians in Minneapolis, Waterloo, Iowa, Rockford, Ill., and other small communities." Since the practice was so widespread, there were several resolutions on the subject in the American Medical Association. Nor has the physicians' practice of taking rebates been carefully confined to eye-glasses. Doctors have similarly engaged in the practice of obtaining rebates from pharmacists and makers of braces and splints. "The development of roentgenology as an important medical specialty and the establishment of clinical pathologic laboratories to which physicians send patients for the making of highly technical and often costly tests have intro-

[2] Nor is there the least suggestion in the evidence that any doctor was corrupted.

[3] The respondent points out that a competitor of the petitioners discontinued the same practice *after* the taxable years in question. (Resp. 8.)

duced new sources of rebates, kickbacks and commissions." (Resp. 8-9, 21-26.)[4]

2. The opening premise of the respondent's argument is that he who seeks a deduction must "show that he comes within the terms of an applicable statute." (Resp. 11.) This assertion has a peculiarly strange ring in this case. For it is the respondent who has ignored "the terms" of the statute in order to disallow the deduction. The respondent's views rest not on the statute, but on some nebulous doctrine of public policy which nowhere appears in the statute. The Tax Court put the matter quite bluntly. In the words of that Court, the payments "are not deductible as ordinary and necessary expenses because the contracts under which these payments were made violated public policy." (R. 196.)

3. The respondent's position does not improve when he denies the existence of a conflict with decisions of this Court and other Courts of Appeals. (Resp. 18-19.)

As regards *Commissioner* v. *Heininger*, 320 U. S. 467 (1943), the respondent merely echoes the same view which this Court rejected in that case. There, as here, the Government argued that its position was "supported by a number of decisions denying the deduction of expenditures incurred as the result of activities which were illegal or contrary to public policy." Brief for the Petitioner, p. 12, *Commissioner* v. *Heininger*, *supra*. But as this Court held, even under a principle of public policy a business outlay is deductible unless the deduction would "frustrate" some "sharply defined" policy directed against the taxpayer. 320 U. S. at 474. The Court found no such "sharply defined" policy in the *Heininger* case, where the expenses were occasioned by fraudulent practices via the mails which contravened specific federal statutes. In this connection

[4] The anti-trust suit to which the respondent refers (Resp. 15, n. 4) was directed against price fixing and not rebates as such. See R. 202-221. The Court below placed no reliance on that suit, to which the petitioners were not parties.

the Court emphasized that those statutes did not purport to impose any penalties for the proscribed conduct. The reasoning of the *Heininger* case is *a fortiori* applicable here. In paying the rebates the petitioners did not incur any penalty which the deduction would mitigate. Indeed they did not incur any sanction whatsoever which a deduction might conceivably "frustrate."

In *Jerry Rossman Corporation* v. *Commissioner*, 175 F. 2d 711 (C. A. 2, 1949), the Court of Appeals for the Second Circuit held that a deduction which is otherwise allowable under Section 23(a)(1)(A) may not be disallowed unless the deduction would "frustrate" a sanction imposed on the taxpayer. The Court further held that the same rule applied even if the sanction was a penalty.[5] The decision below is necessarily in conflict with the *Rossman* decision because under no circumstances could the deduction "frustrate" any sanction directed against the petitioners.

The respondent's attempt to distinguish *Anderson* v. *Commissioner*, 81 F. 2d 457 (C. A. 10, 1936), and *Helvering* v. *Hampton*, 79 F. 2d 358 (C. A. 9, 1935), completely misses the point of his so-called public policy doctrine. If that doctrine properly applies, those cases were erroneously decided. According to the respondent's doctrine of public policy, an outlay reflecting a legal wrong is not deductible because a deduction would mitigate or encourage the consequences of the proscribed conduct. Nevertheless in the *Anderson* and *Hampton* cases deductions attributable to negligence and fraud were sustained. The respondent's effort, for the purposes of this case, to distinguish the deduction of civil damages has been appropriately labeled "arbitrary." See Note, 54 Harv. L. Rev. 852, 856 (1941); Pet. 15. On other occasions the respondent has similarly disparaged the distinction. See, *e. g.*, *Helvering* v. *Hamp-*

[5] In the *Rossman* case itself the Second Circuit decided that there was no "frustration" because the violation concerned was innocent. The matter of innocence related only to the question whether the particular sanction involved in that case would be "frustrated."

ton, supra, at 359; *International Shoe Co.,* 38 B. T. A. 81, 95 (1938).

4. In final analysis the respondent is invoking some extra-statutory principle which is conveniently "unconfined and vagrant." Cf. *Schechter Corp.* v. *United States,* 295 U. S. 495, 551 (1935). The respondent would disallow all deductions which he considered against public policy. Obviously there are no discernible limits to the powers of censorship which the respondent would eagerly assume in the process of collecting taxes. For public policy is essentially indefinable unless vague generalities are considered a definition. The Tax Court's opinion in this case is extremely illuminating in this respect.

That Court defined public policy as "the public good. Everything that tends clearly to undermine that sense of security of individual rights, whether of personal liberty or private property, which any citizen ought to feel, is against public policy." Next the Tax Court redefined public policy as "the community common sense and common conscience extended and applied throughout the state to matters of public morals, public health, public safety, public welfare, and the like; it is that general and well settled public opinion relating to man's plain, palpable duty to his fellow men, having due regard to all the circumstances of each particular relation and situation." Then the Court further defined public policy as prohibiting "that which has a tendency to be injurious to the public welfare." (14 T. C. at 1079-1080.) Surely in allowing the deduction of "ordinary and necessary" business expenses Congress did not authorize the respondent to censor deductions according to his notions of "security of individual rights"; "common sense and common conscience"; "public morals, public health, public safety, public welfare, and the like"; "man's plain, palpable duty to his fellow men." Yet the decision below hardly authorizes the respondent to do less.

The vast implications and consequences of the decision below were acutely anticipated in a penetrating appraisal of the respondent's public policy doctrine:

> "Once the courts attempt to deter undesirable business activity through the disallowance of various business expenditures, they must face a series of increasingly indefinite factual situations. The simplest is where the expenditure may be considered the penalty of a previous adjudication of unlawful conduct; these are the fines, judgments, and legal expenses. The Courts have said that public policy requires this method of deterrence only where there has been a prosecution by the government. The second situation is where either the actual expenditure or the activity in which it was incurred is in violation of law; here the expenditure is habitually disallowed. The third factual situation differs from the second in that while the activity is not in violation of law, nevertheless it is considered contrary to the best public interest.
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> "In the first two situations, the sources of policy are confined to the criminal and regulatory statutes. Its application is limited to the general deterrence of violations of criminal statutes, and, in regulatory statutes, where there has been a previous adjudication of violations. In the third situation, the sources of public policy are not thus restricted; presumably these sources may be any expression, whether of judicial or legislative origin, of which activities are inimical to the public interest. The only limitations would appear to be two inarticulately expressed judicial standards: the ideal business man and the public welfare.
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> "The rule in the first two situations may perhaps be justified by a principle of statutory construction that the word 'lawful' may be read before a word of 'all-inclusive import'—in this case, before the word 'expense.' But even this principle is unavailing in the third situation, and justification of disallowances on grounds of effectuating public policy must overcome both the contrary import of the statutory language and the countervailing policy against the judicial conversion of a tax on net income into a possibly exorbitant tax on gross receipts. In addition, the extension of the concept of illegality arising from criminal and

regulatory statutes to the concept of effectuation of public policy involves the acceptance en masse of all the artificiality such a vague standard must necessarily contain. The negligible relation of such a standard to the determination of what the tax burden of an individual taxpayer should be indicates that even though the restricted concept of illegality be retained, the broad concept of effectuating public policy should be discarded. To do so will, of course, result in the loss of haphazard additions to the national revenue. But increases in revenue should come either from an extension of tax liability or from an increase in rates, rather than from the distortion of a relatively rational system of taxation." Note, 54 Harv. L. Rev. 852, 858-860 (1941).

Respectfully submitted,

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